Diversification and Asset Allocation

Diversification is a technique used to help reduce risk. When you diversify your investments, you decrease the chances of having them at least partly in the wrong place at the wrong time. By spreading your investments over a variety of asset classes, you help reduce your overall investment risk if any one asset class performs poorly.

Investment Concepts

How Diversification Works

While there are thousands of different investments out there today, they consist of only three core asset classes, and they are: stocks, bonds, and cash equivalents. Each of these asset classes reacts differently to changing market and economic conditions.

- **Stocks** A stock is a share of ownership or equity in a corporation. Stocks have historically provided the highest returns, but with the most risk and volatility (short term price fluctuations). Within your employer's retirement plan, an equity investment option invests in an underlying fund, which typically invests in numerous companies, in many different industries. If one company or industry has problems, the investment option may not suffer a major loss because the underlying fund is sufficiently diversified.
- **Bonds** A bond is a debt security issued by a company, municipality or government agency. A bond investor lends money to the issuer, and in exchange the issuer promises to repay the loan amount on a specified maturity date. The issuer also must pay the bondholder periodic, fixed interest payments over the life of the loan. Bonds generally have less risk and volatility, but have historically produced lower returns than stocks. Within your employer's retirement plan, a bond investment option invests in an underlying fund that usually invests in bonds with varying maturity dates, and issued by various entities.
- **Cash Equivalents** Cash equivalents are short-term, highly liquid, and relatively low-risk debt instruments issued by governments, financial institutions, and corporations. Cash equivalents have provided the lowest returns of the three asset classes, but have shown very little volatility. Most employer retirement plans offer this investment option in the form of a money market account or an account with a fixed interest rate or a rate that varies during the period. An investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at \$1.00 per unit, it is possible to lose money by investing in the fund.

You can further diversify your retirement plan assets by investing in different types of investment choices offered by your plan. For example, by spreading money among the plan's investment choices – such as an equity investment option, a bond investment option, and a cash equivalent investment option – you would diversify your plan assets more than by investing in just one type of investment option.

Diversification is just the first step in your investment strategy. Once you decide to diversify your retirement plan account assets, you need to decide how much to contribute to the various types of investment choices. **This step is called asset allocation**. While diversification and asset allocation neither assure a profit nor protect against a loss, they can be sound investment strategies

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Asset Allocation is the strategy of diversifying your account over a variety of asset classes or investments. Today, individuals are challenged to fund and self-direct their own retirement investments through vehicles such as group retirement plans. To meet this challenge, each investor must develop an investment strategy that carefully balances between risk tolerance, investment objectives, and time horizon.

Market Timing - 1.8%

Miscellaneous Factors - 2.1%

Security Selection - 4.6%

Asset Allocation - 91.5%

Source: Study entitled "Determinants of Portfolio Performance," by Gary Brinson. Updated in Financial Analysts Journal, May/June1991. Copyright Ibbotson Associates 2004. All rights reserved.

- Risk tolerance Risk tolerance has to do with how you really feel about the affects of risk on your investments. Are you concerned when the market dips? How anxious do you get? Do you have the patience to ride out these periods? Some people are just naturally conservative. Others are aggressive risk takers. Still others are somewhere in between. Decide on what type of investor you are and invest according to your willingness to accept risk. Remember, though, that most investment choices have some degree of risk. Some risks, such as inflation, aren't quite so apparent to the average investor, so be sure to take them into consideration.
- Investment Objectives What retirement lifestyle are you trying to achieve?
 Will you lead a relatively similar lifestyle? Will you travel frequently, or engage in expensive hobbies? Or will you downsize to a smaller home?
- **Time Horizon** What is your time horizon for each of these objectives? Younger individuals typically have more time to save to meet their retirement goals and make up any short-term investment losses that might occur. As retirement gets closer, many people generally have less tolerance for risk because they have fewer years in which to meet their goals.

The goal is to balance these variables in a way that may help you meet your investment objectives, while maintaining an acceptable amount of risk. One of the most effective ways to establish this equilibrium is to build an investment strategy with asset allocation.

Why Asset Allocation?

According to experts, how your money is allocated to different asset classes plays a more significant role in the overall performance of your investments than does the selection of the individual securities within an asset class.

The chart to the left illustrates the findings of a study conducted on the performance results of some of the nation's largest pension funds. Over 90 percent of the fluctuation of an investment portfolio's performance can be explained by asset allocation.

Taking the First Steps

How do you determine the diversification and asset allocation mixes that work best for you? Your retirement plan enrollment booklet provided by The Hartford has worksheets, tools, and examples to help you make your decision. Contact your financial professional if you need additional guidance.

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